Annex 1. Summary of Background Papers

Capital Flows to Latin America in the Aftermath of the Commodities Super-Cycle[1]

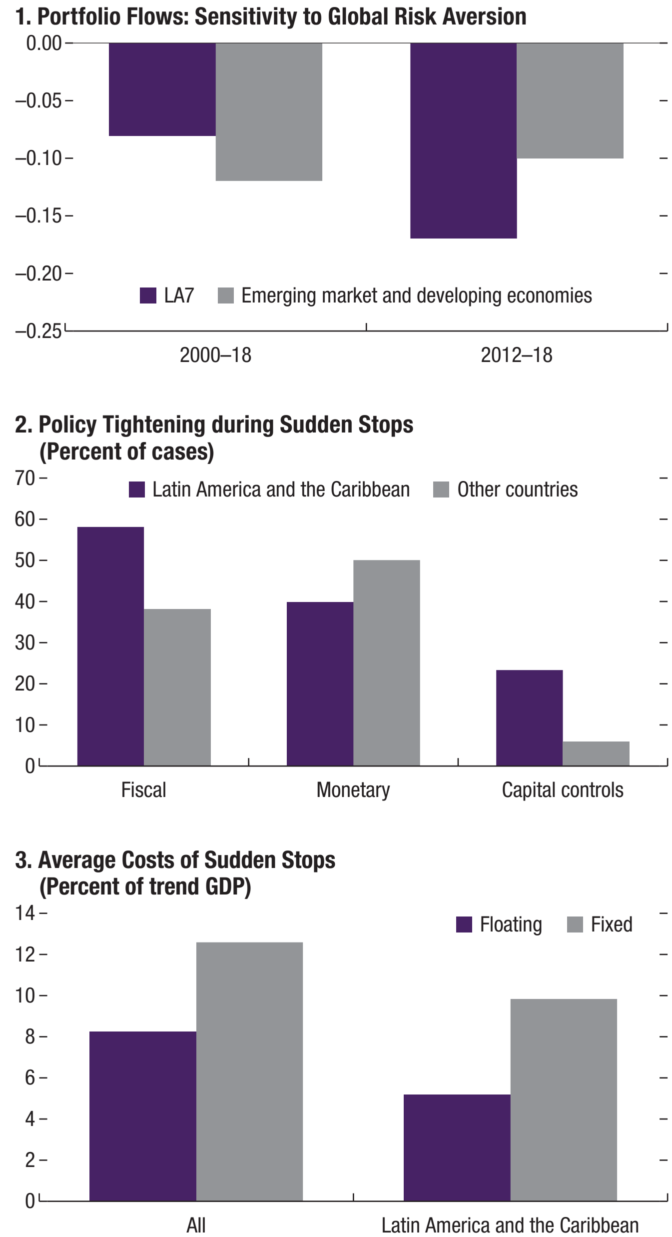
Volatile capital flows pose important challenges to countries in Latin America and the Caribbean (LAC), given their dependence on external savings to finance investment. Since 2012, portfolio inflows have driven most of the variability of capital flows to the region. Furthermore, the importance of global risk aversion and growth differentials relative to advanced economies in driving capital flows has increased in recent years. This, in turn, increases the likelihood of a sudden reversal of capital inflows if growth in the region continues to falter and global investors' sentiment shifts in light of significant policy uncertainty.

Emerging markets are prone to experience boom–bust patterns in capital flows, entailing substantial economic costs and forcing painful adjustment. High fiscal deficits, large current account deficits, and high levels of liability dollarization increase the vulnerability of countries to the adverse effects of sudden stops, whereas low inflation and adequate reserve buffers reduce susceptibility to the adverse effects of disruptions in capital flows.

The background paper discusses a number of policy options to deal with sudden stops. The empirical analysis shows that countries with floating exchange rate regimes tend to experience shorter sudden stops in capital flows. Flexible exchange rate regimes are also associated with substantially lower output losses from sudden stops. In addition, a tighter monetary policy stance following a sudden stop episode is linked to a reduction in its duration and the ensuing deceleration in growth. Finally, increasing capital controls does not affect the duration of sudden stops in a significant way.

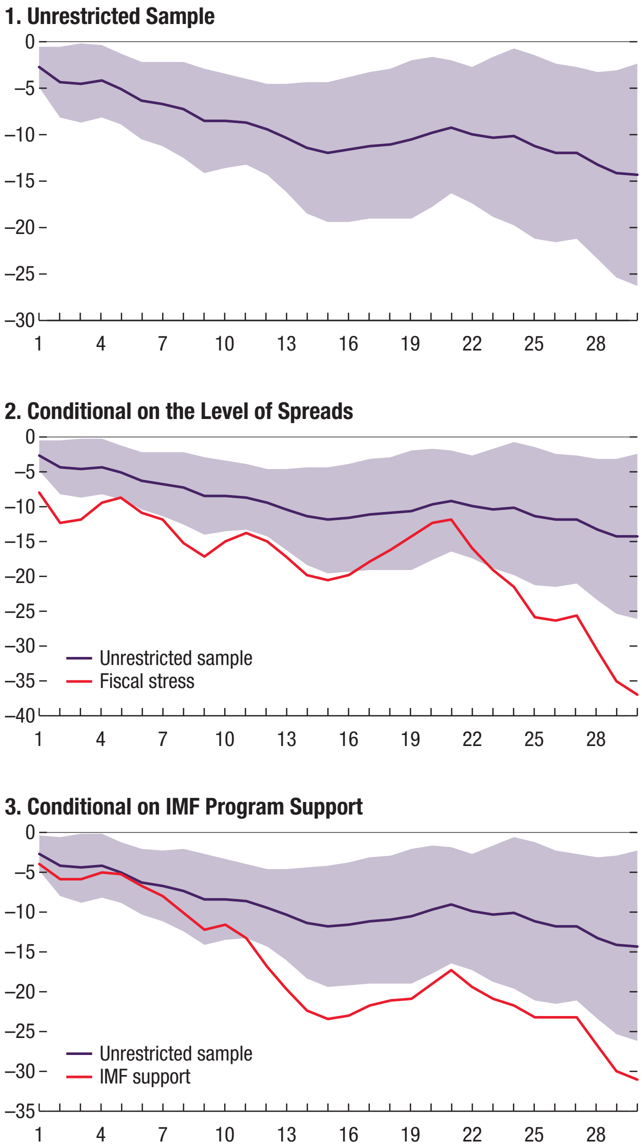
[1]Based on the background paper "Capital Flows to Latin America in the Aftermath of the Commodities Super-Cycle" (IMF 2019a) prepared by Carlos Goncalves, Antonio David, and Samuel Pienknagura.

Annex Figure 1.1. Capital Flows and Sudden Stops



Source: IMF staff calculations.
Note: LA7 = Argentina, Brazil, Chile, Colombia, Mexico, Peru, Uruguay.

Annex Figure 1.2. Effects of Consolidation Announcements on EMBIG Spreads
(Basis points)



Source: IMF staff calculations.
Note: Estimates based on local projection methods. Shaded area indicates 90 percent confidence intervals using HAC standard errors. EMBIG = J.P. Morgan Emerging Market Bond Index Global.

Sovereign Spreads and Fiscal Consolidations[2]

Lower commodity prices, mediocre growth, and a prolonged period of low global interest rates have contributed to rising public debt in many countries in LAC. Against this backdrop, and amid a more challenging external environment, financial markets' perception of credit risk in LAC has deteriorated somewhat. This has led policymakers in many of these economies to announce fiscal consolidation measures aimed at reducing public debt and improving confidence in the sovereign, as measured by sovereign bond spreads. Nevertheless, empirical evidence quantifying the effects of fiscal policy on sovereign spreads has been elusive.

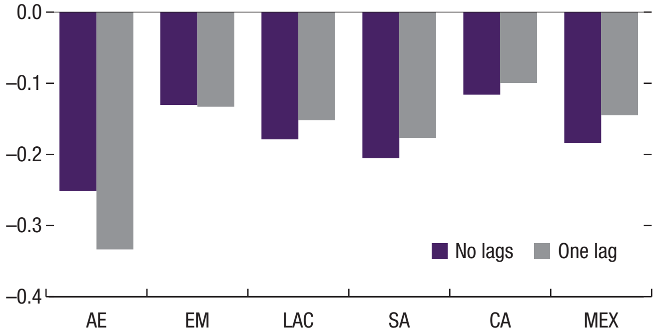
Using a new database on fiscal policy news, the background paper investigates the effects of fiscal consolidation announcements on sovereign spreads in LAC during 2000–18. The results show that sovereign spreads decline significantly following news that consolidation measures have been approved by Congress, particularly in periods of high sovereign spreads or in countries under an IMF program.

In addition, packages are more successful—leading to smaller output losses and larger reductions in the public debt-to-GDP ratio—when sovereign spreads significantly decline following a fiscal consolidation announcement. These results constitute direct evidence that if confronted with a situation of fiscal stress, credible consolidation efforts get rewarded. These confidence effects are crucial in mitigating the drag on economic activity in the aftermath of fiscal consolidation.

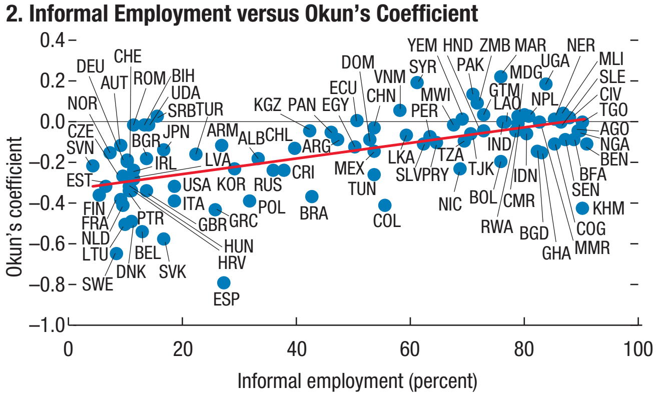
[2]Based on the background paper "Sovereign Spreads and Fiscal Consolidations" (IMF 2019c) prepared by Juan Yépez, Antonio David, and Jaime Guajardo.

Annex Figure 1.3. Informality

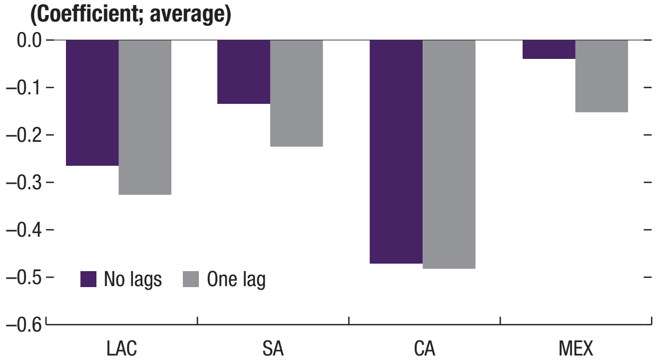
1. Unemployment's Responsiveness to GDP Changes (Okun's coefficient; average)



2. Informal Employment versus Okun's Coefficient



3. Informality's Responsiveness to GDP Changes (Coefficient; average)



Sources: Haver Analytics; International Labour Organization; and IMF staff calculations.
Note: AE = advanced economies; CA = Central America; EM = emerging markets; LAC = Latin America and the Caribbean; MEX = Mexico; SA = South America.

Labor Market Dynamics and Informality over the Business Cycle in LAC[3]

Labor markets in LAC are characterized by high levels of informality, low female participation rates, and relatively rigid employment protection legislation. The results presented in the background paper show that informality plays an important role in the dynamics of labor markets in the region.

Informality is countercyclical, and the formal-informal adjustment margin reduces the importance of the employment–unemployment margin, that is, informality dampens the usual Okun's coefficient relating unemployment to cyclical changes in GDP. Moreover, changes in aggregate participation rates are positively related to changes in GDP, but there is some evidence that the female participation rate is countercyclical during recessions in LAC.

Rigid employment protection legislation, such as higher redundancy costs, cumbersome dismissal regulations, and relatively high minimum wages are associated with increased informality. Moreover, evidence also suggests that informality makes the adjustment to shocks slower, with a negative impact on productivity and growth. In particular, LAC countries typically adjust more slowly to economic shocks compared to other countries in part because of rigid employment protection legislation.

[3]Based on the background paper "Labor Market Dynamics and Informality over the Business Cycle in LAC" (IMF 2019d) prepared by Jorge Roldos, Antonio David, Camila Pérez, and Samuel Pienknagura.